genial Equity Research

SLC AGRICOLA

Farm Day 23: Biomagic

LatAm Agribusiness

Main takeaways:

(i) El Niño seems to scare the market more than the company; effect on SLC (-1.8 bags/ha crop 23/24) is below what we expect for the rest of the market **(ii)** The balance is positive: SLC loses less than peers in El Niño and gains the same when the wind is in favor. In La Niña, production can be up to +2.4 bags/ha; **(iii)** Cost of chemical pesticides should fall. We expect a 1/3 reduction in the cost of inputs due to the increased use of biological pesticides; **(iv)** valuation supported by Price/NAV (0.8x) bellow historical and EV/EBITDA 24E (6.3x) offering an entry point, as we are observing a price asymmetry caused by how consensus still do not get quite right lower costs that are coming ahead

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Company

SLCE3 BZ Equity
Buy

Price: R$ 40,41 (05-July-2023)
Target Price 12M: R$ 47,00

We attended SLC's Investor Day 2023 this week. The event at Pamplona Farm (GO) held for analysts and investors, popularly known as "Farm Day", reinforced our optimistic view on the Company's quality and superior performance. After the event, which featured lectures by agronomists and other professionals specialized in the day-to-day operations of both the Pamplona farm and other SLC farms, we were left with the perception that there is a vanguard of technology being applied, from the aspect of cultivation practices as well as climate monitoring. We believe that the measures that the Company has been taking should continue to sustain the advances in crop yields.

The dedication of senior management to encourage the use of technologies in the field and the use of biologicals in up to 15% of the planting area positively reinforces our confidence in SLC. We continue to have favorable views on the stock, but our thesis is more heavily linked to good management than necessarily to commodity dynamics (soybeans and corn). The rationale behind this outlook is our belief that the prevailing market is accommodating the possibility of a further reduction in profit margin from the El Niño effect, as opposed to our projections of possible cost-cutting measures (mostly in pesticides).

El Niño seems to scare the market more than the company. However, we recognize the possibility of the 2023/24 harvest being influenced by El Niño and its more adverse climatic characteristics for the crop, through severe droughts in the North and Northeast of the country. SLC pointed out that this climatic circumstance usually generates a negative impact on soybean production of an average of -1.8 bags/ha, considering the current production rate of 66 bags/ha. We noticed that SLC was careful to warn about the consequences but considering what measures the Company will adopt to reduce the negative impacts on production.

Therefore, we emphasize that at recurring moments of the event the topic came into play, emphasizing the main perspectives, especially in view of the climatic irregularity of El Niño. The influence of El Niño on SLC has been modest, if we consider the historical behavior of production. Our view is that a reduction of -1.8 bags/ha in production is below the market average since existing agricultural land is fully developed, unlike previous events as land was still in the process of development. In the case of cotton, the previous vulnerability to productivity was around 3-5% as indicated by the Company, with the main threat in Bahia (BA) due to the prerequisite of absolute rainfall during the crop evolution.

We estimate that ~70% of crop production in Mato Grosso do Sul (MS), Paraná (PR), São Paulo (SP) and Minas Gerais (MG) was sown in a period considered high risk for El Niño losses, typically linked to the planting months of March and April. Regarding Paraná and the southern region of Mato Grosso do Sul, the yield potential of at least 60% in the planted assets is still undefined, with the final production of the crop susceptible to drought and low temperature conditions during the entire month of June. During this period, ~10% of the agricultural territory in the mentioned states will go into budding.

In other words, for the most part, other producers may suffer a negative impact to a greater extent than SLC. Even considering losses at a more limited pace, we have reasons to believe that El Niño impacts are coming in notably less intense cycles than previous ones, especially compared to the maximum intensity observed in 2015-16.

The balance is positive: SLC loses less in El Niño, and gains equally when the wind is in favor. If on the one hand SLC is little impacted during El Niño, on the other hand during La Niña phases production tends to increase by +2.4 bags/ha, according to the historical average. The gain is close to what we observe in peers. We believe that some factors make SLC able to cushion negative climate impacts when the event is unfavorable to producers, but still enjoy gains when there are events that help rather than hinder. Among them, we list the **(i)** low geographic concentration, which added to **(ii)** crop diversity; as well as through **(iii)** the implementation of specific procedures to combat drought, among them the expansion of irrigated zones in a moderately longer timeframe; and the **(iv)** early start of the second cotton crop.

About 27% of SLC's cotton production comes from Bahia, a state that suffers greatly from drought during El Niño. In our assessment, starting the planting of the second crop earlier will help SLC mitigate the negative consequences on production volume brought by climate effects. The Company has about 12k ha of irrigated land, 83% of which is located in Bahia.

Use of biodefensives on a larger scale will unlock value. One of the factors that make us excited about a better cost configuration is the expansion of the agricultural biology project, which was initiated by SLC in 2018 at Palmares farm (BA), to an increasingly larger arable area, possibly reaching 15% of the total planting area (conservative estimate) vs. ~10% today. Biopesticides, or more formally known as biodefensives, are agricultural products grown from an organically active element originating from nature. The application of these products is designed to exterminate targets such as diseases or pests that cause crop damage, without negatively impacting the environmental ecosystem, unlike chemical pesticides, which have a higher cost and more negative externalities to the soil and ecosystem.

Originally consisting of just a humble structure of containers and PVC tanks, the project has seen substantial growth and development over the years. Currently, the static biological production capacity exceeds 325k liters. However, it is essential to note that static capacity does not denote aeration and production capacity, as the type of organism being multiplied determines the required hours of fermentation and incubation. Bacteria, for example, typically require a 48-hour period, while fungi need 72 hours.

To streamline operations, the project collaborates with two partner companies that provide SLC with the inoculums in culture medium. The multiplication process is carried out on the farm along with the purchase of commercial products. This incorporated approach allows the Company to maintain a continuous flow of biological production, which raises the prospect for expansion. In 5 years, the project has taken a much larger proportion within SLC, from 1% to 10% of the arable area, with biodefensives being used now in basically all farms of the group.

The biofactory, responsible for the production process, is designed to have regulated access to ensure optimal functioning of the biological components. On most farms, the biofactory is a precast structure, however, at Pamplona (GO) the range of biofactories is wider, encompassing masonry. The production tanks are strategically arranged and made of stainless steel. They are designed to control the internal environment, maintaining the desired temperature, aeration and humidity to ensure a productive environment for biological multiplication. Meticulous quality control procedures are implemented throughout the production cycle. This includes all parts of the cycle, from the arrival of the inoculum to its introduction into the culture medium, initiating a series of thorough and investigative analyses.

Management tools are mainly categorized into three types of biological controls. **(i)** SLC uses microbiological tools that are not discernible without technical apparatus. These microbiological tools are subdivided into three types: bacteria, fungi and viruses. These microbial-based tools have versatile benefits, ranging from management of sun pests, nematodes to caterpillar control, as well as facilitating nitrogen fixation. **(ii)** The second category is macrobiological tools, which include parasites or predators. These organisms are currently introduced into the mine by partner companies, although plans for future collaboration remain undefined. **(iii)** Finally, the Company uses semiochemicals, synthetic agents subdivided into two categories. Pheromones are the main semiochemical tools, functioning as food attractants. These compounds act as lures in the form of strips that are introduced into the crops, sending seductive olfactory signals that attract adult insects. Once attracted, the adult insects come into contact with the alchemical substances and are contaminated, interrupting the cycle of their proliferation.

Cost of chemical pesticides expected to fall. We currently assign a negligible chance of adverse deviation and anticipate that the upcoming commodity/cost reduction will have a favorable impact. Forecasts for the coming months of 2023/24 could prove pivotal, given that the market assigns minimal downside risk. In summarize, we believe SLC's approach to maintaining and controlling quality of work is diligent and comprehensive, employing micro and macro biological agents, as well as semi-chemicals.

We expect that this management in precision will be evident in cost reductions going forward, the increasing expansion of these practices in the crop area, reduces the Company's total exposure to price volatility of chemical pesticides as inputs, since the production of biological pesticides is basically in-house, and the total cost is lower and more efficient than purchasing from third parties. We have reasons to believe that a considerable portion of the market does not yet consider this cost reduction in SLC's valuation.

In terms of maturity, all farms have reached the proposed goal for the expansion of the use of biological pesticides, so we believe that the estimate of 15% is conservative. We observe advantages beyond cost reduction, since the gain in productivity should be notorious, for example, by generating the possibility of the fungicide being applied when the cotton is still small, something unfeasible if applied with chemical pesticides. Thus, we believe that the partial replacement of chemical pesticides by biologicals should generate, for the next 5 years, a cost cut with the purchase of inputs in ~1/3 vs. the historical average.

In the case of selective and localized application there is a very positive evolution in efficiency. Our perception is that Brazil uses a larger volume of pesticides compared to competitors (USA and Argentina), as Brazilian lands are affected by more pests. Therefore, the use of biological pesticides, combined with digital agriculture, will benefit Brazil more and further increase competitiveness against Argentina and the USA. Added that to the possibility of a second crop, we probably going to see an improvement in productive efficiency beyond international peers.

Our Take on SLC

SLC also released, a day before the event, a statement with a revised forecast of its production and expenses estimates, mainly decreasing the volume of input purchases due to the combination of lower costs per hectare and better yields. On the production side, the Company closed 2022/23 with 65.1 bags of soybeans/ha. With the best performance being achieved on the Panorama farm (BA), which produced just over 83 bags of soybeans/ha. For the 2023/24 crop, El Niño may promote a reduction in this level of production found in Bahia, however, we estimate that losses should be contained at ~2 bags/ha, which would bring production to a target of 70 bags/ha.

On the input side, we already believed in the cost reduction potential for 2023/24, however, the announcement for 2022/23 came out as a constructive surprise. Therein lies **our main agenda** for a **BUY rating support**: The consensus is putting a cost increase in the account for 2023/24, compared to our estimates, thus presenting a price asymmetry that seems attractive to us.

"Biomagic". Although during Farm Day 2023 the Company focused on the use of technology in the field, with satellite microclimate monitoring, automation of harvesting equipment and reduction of manual labor, we believe that a relevant portion of the market already attributes efficiency gains to the use of these devices. However, in the lectures SLC also directed attention to analysts on the effects that biological agents should cause when used as pesticides, acting as reduction catalyst for inputs cost and increasing the profitability of production. This for us is not yet being accounted for in the market consensus score.

As we have commented throughout the report, from a long-term perspective, the Company remains persistent in improving the application of modern technology, including the use of biologicals, which could result in reduced volumes of chemical pesticides. We believe that 1/3 of the cooling in input costs should be attributed to the implementation of biological solutions and site-specific application, respectively.

We currently see the Company's shares trading at approximately **0.8x Price/NAV 23E** vs. ~1.05 historical average, implying that even before the Company adopted a more vigorous asset light composition (which eventually lowered NAV), the market was paying a higher valuation than it is today. In other words, with the new land appraisal, which was done by Delloite recently, SLC looks even more discounted to us since the NAV ignores almost 2/3 of the Company's farmland, which is leased.

Trading at **24E EV/EBITDA** of **6.3x**, in addition to the discount via Price/NAV, we believe in a **gradual improvement in EBITDA to 2024** if compared to our previous model, driven by lower input costs as the use of pesticides works its magic. We reinforce our **BUY recommendation** for our **Top Pick of the agribusiness sector**, with SLC seeming to offer an interesting entry point, with **R$47,00** as our **Taget Price,** pointing out to **an upside of +16,31%**.

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Genial Rating

	Definition	Coverage
Buy	Expected return above +10% in relation to the Company's sector average	**46%**
Neutral	Expected return between +10% and -10% relative to the Company's industry average	**44%**
Sell	Expected return below -10% in relation to the Company's sector average	**5%**
under Review	Under review	**5%**

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